ETF Securities Commodity Research:
Energy Wars: OPEC fighting a losing battle

Summary

- OPEC’s attempts to unseat high-cost production from other countries appears to be failing.
- The initial market-positive reaction OPEC received to cutting production when it changed tactics in 2016 is fading fast as the market remains sceptical about the cartel’s ability to “do whatever it takes”.
- US shale and other unconventional oil have learnt to operate in a lower oil price environment. We expect US oil production to continue to expand despite prices being less than half the level reached in 2014.

Changing course after failure

In 2015, we began a research series documenting the price war that The Organization of the Petroleum Exporting Countries (OPEC) started in retaliation to the growing market share of high-cost producers. In this piece, we recap some of those themes and provide an update.

Envious of high-cost producers eating up market share and disrupting the status quo, OPEC engaged in a price war in 2014. While driving prices down sharply, the cartel failed miserably in improving the economic outcomes of its members. Venezuela and Nigeria have been crippled with lower oil prices. Venezuela lives with inflation measured in the thousands and frequent rioting on the streets. The country’s debt is priced as if it is close to default. Terrorists are taking advantage of the weakness of Nigeria’s government finances. The Nigerian Naira has depreciated by close to 50% since 2014.

Saudi Arabia led OPEC into battle to pump out oil at an unprecedented pace. Oil prices collapsed from over US$100/bbl in 2014 to under US$30/bbl in 2016. After having narrowly escaped the ‘Arab Spring’ in 2010 due to a very strong spending programme, Saudi Arabia clearly can’t afford to let its revenues continue to drop as drastically as they have done. After raising money from debt markets and engaging in a belt-tightening fiscal programme, the country is still struggling. Saudi Arabia’s fiscal breakeven stands at US$78/bbl (down from US$106/bbl in 2014), which is considerably higher than current oil prices. The Saudi government aims to sell part of its state-owned oil company, Saudi Aramco, with proceeds to go into a public investment fund. But to get a satisfactory valuation for the company, Saudi Arabia requires higher oil prices.

Belatedly realising its mistake, Saudi Arabia led OPEC to cut production at the turn of 2017. So determined it has been to do this, it managed to broker a deal among 10 non-OPEC countries to participate alongside. Originally a 6 month plan to reduce 1.8mn barrels of production from October 2016 levels, the cartel has just renewed its deal for another 9 months to March 2018 last month.

The market has not been impressed with the latest extension. Prices fell as more was expected from the group after the cartel said that they will “do whatever it takes”.

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Notably absent from the recent extension was any wording around an option to extend the deal further (like they had in the first deal). This indicates it was a struggle to get to a nine-month extension and talk of deeper cuts that Saudi Arabia had advocated were not entertained.

**Compliance within current deal**

We noted in “Little honour among OPEC cartel members” that compliance among individual OPEC members in the current deal was strong but given that a number of OPEC countries are exempt from the deal, the group is not cutting anywhere near as much as the 1.2mn barrels it was supposed to.

Saudi Arabia, who shoulders most of the burden for cutting output, removed a lot of production in the first month of the deal, but has since let production increase. Although it is still compliant with the parameters of the deal, the fact that production is rising highlights the difficulty in fighting against seasonal trends.

As political rifts between OPEC members grow, we question the extent to which OPEC members will remain compliant. Last week, Saudi Arabia and a number of Gulf Cooperation Council countries severed diplomatic ties with Qatar. The land border between Qatar and Saudi Arabia has been shut and sea and air routes with the United Arab Emirates, Bahrain and Egypt have been closed. Under such pressure, Qatar may decide to break ranks with the Saudi-led OPEC cartel and produce more than its allocated quota. Although Qatar is small (producing just over 0.6 million barrels of the 31.7 million barrels that OPEC produced last month), its lack of compliance could encourage others to abandon their targets.

Transparent reporting of production levels of non-OPEC countries participating in the deal still does not exist. Although Russia claims that it was fully compliant with the 0.3 million barrel cut that it signed up to, as of last month’s OPEC report, it had only cut 0.2 million1.

**US resilience in production**

While OPEC struggles to convince the market that it is doing enough to reduce global inventories of oil, production in the US, Canada and Brazil continues to increase.

US production of oil in particular has been resilient. While US oil rigs had fallen by over 80% after the start of the price war in 2014, they have more than doubled from the low point reached in 2016. Still, rigs in the US are less than half the number there were at the peak. Production however, is close to the peak. This comes as a result of growing rig efficiency. The low price environment has aided technological innovation.

Breakeven prices for shale oil production has fallen from over US$80/bbl in 2014 to below US$40/bbl in 2016.

1 In OPEC’s November report, Russia was producing 10.59mb/d in October and in OPEC’s May report, Russia was producing 10.39mb/d

There are efficiency gains in other US non-conventional oil production. Shale oil has seen drilling speed (measured by drilled footage per day) increase continuously through the 2011-2016 period. Drilling speed in the Gulf of Mexico shelf increased substantially in between 2014 and 2016, indicating that other non-conventional oil production such as off-shore is experiencing similar gains in efficiency.

Oil prices are likely to trade in the US$40-55/bbl range, with risks to prices remaining in the lower section of that range amid the ongoing production glut.

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